No. 77-1724

IN THE

Supreme Court of the United States

October Term, 1978

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITIONERS' BRIEF

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INDEX

Citations

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Opinions Below

The opinions of the District Court (Werker, *J.*) are reported at 404 F.Supp. 1172 (S.D.N.Y. 1975) and at 426 F.Supp. 844 (S.D.N.Y. 1977). The District Court also filed an unreported opinion and order denying a motion for reargument on January 7, 1976. The opinion of the Court of Appeals is reported at 567 F.2d 1208 (2d Cir. 1978). All four opinions below are reproduced in the Appendix in this Court (A. 5-48).

Jurisdiction

The judgment of the Court of Appeals was entered on January 11, 1978, and a timely petition for rehearing was denied on March 9, 1978. A petition for writ of certiorari was filed on June 2, 1978 and granted on October 2, 1978. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Statutes Involved

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* and the Delaware Corporation Law, Del Code tit. 8, § 101 *et seq.* The pertinent provisions of those statutes are set forth, with an index thereto, in Addendum A at the back of this brief.

Question Presented

Plaintiffs*, two out of 90,000 shareholders of a $1 billion mutual fund incorporated under the laws of the State of Delaware, seek—by means of a derivative action—to compel the fund to sue its investment adviser and various directors of the fund to recover from them an investment loss sustained by the fund in the regular course of its business.

Three years prior to the filing of the derivative action, the fund had initiated litigation against the seller of the commercial paper notes which were the subject of the investment loss. One year subsequent to the filing of the derivative action, the fund entered into a settlement with the seller of the notes, pursuant to which the fund received a multi-million dollar recovery.

The disinterested directors of the fund, who are not defendants in the derivative action and who constitute a quorum of the board of directors, then considered the claims raised in the derivative action. After an in-depth study of the matter, with the aid of independent special counsel, they unanimously concluded, in the exercise of their business judgment, that maintenance of the derivative action was contrary to the best interests of the fund and its shareholders. The disinterested directors thereupon instructed the fund's litigation counsel to move to dismiss the derivative action.

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* In this brief respondents are referred to as "plaintiffs" and petitioners as "defendants".

The District Court held, in its first opinion, that the disinterested directors had the power, as a matter of business judgment, to determine on behalf of the fund that the claims asserted in the derivative action should not be prosecuted and that the derivative action should be dismissed. After permitting extensive discovery on the issue of the independence of the disinterested directors, the District Court held, in its second opinion, that they were truly disinterested and independent, and had exercised their business judgment in good faith. Accordingly, the District Court granted the renewed motion to dismiss.

The Court of Appeals, while agreeing that the disinterested directors had acted in good faith, held that they had no power to terminate the derivative action. The Court of Appeals concluded that the Investment Company Act of 1940 impliedly precluded the disinterested directors from exercising their business judgment to forego prosecution of the claim against the investment adviser and the other directors. On this basis, the Court of Appeals reversed and remanded.

QUESTION: Are the disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, incapacitated *as a matter of law* from exercising their business judgment to determine whether maintenance of a stockholders' derivative action against the investment adviser and various directors of the fund, to recover from them an investment loss sustained by the fund, is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholders' derivative action be permitted to proceed, in any and all events, even though the disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

Statement of the Case

This case involves a fundamental issue of corporate governance, raised in the specific context of a mutual fund corporation, to wit: do the disinterested directors of such a corporation—assuming they are independent, informed and acting in good faith—have the responsibility and authority to run the affairs of the corporation, or can a single stockholder, merely by instituting a derivative action, seize the reins of the corporation, render nugatory a sound and well-reasoned exercise of business judgment by the directors, and *compel* the corporation to assert a claim in litigation, the maintenance of which the directors have determined to be contrary to the best interests of the corporation and its shareholders? The underlying transaction in this case did not involve self-dealing of any kind by the investment adviser or the directors, but merely an investment loss sustained in the regular course of business. To preclude disinterested directors from exercising business judgment in such circumstances will undermine the important principle that it is the directors who have the responsibility *and* power to direct the affairs of corporations. The result will be to put the judiciary into the board room.

The facts of this case, as found by the District Court, are not in dispute and were not disturbed by the Court of Appeals, which based its decision on a matter of law.

Fundamental Investors, Inc. ("Fundamental") is an open-end investment company (commonly known as a "mutual fund") incorporated under the laws of the State of Delaware and registered under the Investment Company Act of 1940 (A. 65). Anchor Corporation ("Anchor"), and its predecessor companies, have been the investment adviser to Fundamental for over 45 years.

The purchase of Penn Central commercial paper and its aftermath—1969

On November 26, 1969, Fundamental purchased $20 million of the commercial paper (270-day notes) of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., a leading commercial paper dealer (A. 66). At the time of the purchase, Penn Central commercial paper was rated "Prime" by the National Credit Office, a subsidiary of Dun & Bradstreet, Inc., the most widely utilized commercial paper rating agency in the country (A.95).* Fundamental had a portfolio with a net asset value of approximately $1 billion (A. 66). The purchase of Penn Central commercial paper was a transaction undertaken in the regular course of business by Fundamental, which purchased commercial paper periodically throughout the year as a short-term utilization of funds until they were needed for purchases of portfolio securities in the stock market or for redemption of Fundamental's own shares (A. 82-3). Commercial paper of major national corporations like Penn Central was widely considered by the financial community to be a cash equivalent, the safety of which was not in question (A. 78, 132).

On June 21, 1970, Penn Central, the sixth largest corporation in the country, with assets of over $6 billion, filed a Petition for Reorganization (A. 66). The notes purchased by Fundamental (and many other renowned financial institutions, universities, charitable organizations, etc., most of which purchased their notes *after* the purchase by Fundamental) were not paid at maturity (A. 128-130).

* In October 1969, one month before the purchase by Fundamental, the Interstate Commerce Commission had authorized Penn Central to increase its outstanding commercial paper to $200 million from $150 million, and had assessed it as ". . . in a strong financial condition" (A. 132).

The *Welch* action—1970

On November 4, 1970, following consideration of the matter by the Board of Directors, Fundamental initiated an action, with three other plaintiffs, against Goldman, Sachs & Co. ("the *Welch* action") under the federal securities laws for rescission of their purchases of the notes (A. 66). The Complaint charged that Goldman, Sachs & Co., the exclusive dealer in Penn Central commercial paper, had withheld material, adverse non-public information on the financial condition of Penn Central (A. 87). Within a year, approximately 35 such suits had been commenced against Goldman, Sachs & Co. by other purchasers of the notes (See MDL 56A—*In re Penn Central Securities Litigation,* 325 F.Supp. 309 (J.P.M.D.L. 1971)).*

The *Lasker* action—1973

On February 5, 1973, more than three years after the purchase by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the *Lasker* action") purportedly on behalf of Fundamental (A. 67). The Complaint named as defendants Anchor and all of the persons who were directors of Fundamental at the time of the purchase (i.e., 1969), and charged them with violation of statutory and common law duties in making and retaining the investment for Fundamental in Penn Central commercial paper (A. 49-63).

On July 30, 1973, on motion of all defendants, and prior to joinder of issue, then District Judge Murray I. Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental against Goldman, Sachs & Co. in the *Welch* action (A. 67).

On July 9, 1974, on the eve of the trial of the *Welch* action, Fundamental entered into a favorable settlement as

* Of these, four were tried and the rest were settled.

follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5.25 million in cash and, for the balance of the claim, assigned to Fundamental a 73.75 per cent interest in the proceeds of the $20 million of notes in the Penn Central reorganization proceedings (A. 67).*

The disinterested quorum

On July 24, 1974, at their next regular meeting, the Board of Directors of Fundamental reviewed the status of the *Lasker* action, and determined that the five directors who (a) were not affiliated in any way with Anchor, and (b) were not directors at the time of the events complained of in the *Lasker* action, and (c) were not defendants in the *Lasker* action, would, acting as a quorum pursuant to the by-laws and Delaware law, constitute the Board of Directors to decide what position Fundamental should take regarding the *Lasker* action. The Board of Directors determined that the six other directors, i.e., the four who were affiliated with Anchor and the two who were not affiliated with Anchor but who were named as defendants in the *Lasker* action, would take no part in the decision (A. 69-70).

The five disinterested directors are persons with distinguished careers in business and government** (A. 70):

* A plan of reorganization was approved this year, and the notes have substantial value in the form of stock and certificates of beneficial interest in the reorganized company.

** Plaintiffs, in the proceedings below, challenged the independence of the disinterested directors, suggesting that they had been selected by the defendants for the purpose of aborting the *Lasker* action. The charge is baseless and was rejected by the District Court. The disinterested directors were suggested for nomination by the Directors' Qualification Committee, of which, at all times, a majority (two of three) consisted of disinterested directors (A. 143, 163). Furthermore, two of the five directors who made up the disinterested quorum

Leon T. Kendall is a professional economist and the President of Mortgage Guaranty Insurance Corporation of Milwaukee, Wisconsin. He had been a member of the faculty of the School of Business, Indiana University, an economist for the Federal Reserve Bank, Atlanta, an economist for the New York Stock Exchange, President of the Association of Stock Exchange Firms, and, finally, President of the Securities Industry Association (A. 70);

Dr. Beryl Robichaud is a Senior Vice President of McGraw Hill, Inc. She is also a director of Aetna Life & Casualty Corporation, and the author of two books in the field of business management (A. 70);

William J. Stephens is the retired Chairman of the Board and Chief Executive of Jones & Laughlin Steel Company. He was also a director of several other major corporations (A. 70);

Louis F. Laun was the Deputy Administrator of the Small Business Administration, Washington, D.C. and also had a long career in private industry prior to his government service (A. 70);

Mary S. O'Connor is a director and member of the Executive and Trust Committees of the Central Home Trust Company of Elizabeth, New Jersey. She was also one of the first women officers of International Business Machines Corporation (A. 70).

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that acted as the Board in this case became directors before there even was a *Lasker* action. Laun became a director in 1971 (A. 70) and O'Connor in 1972 (A. 70). The *Lasker* action was not filed until 1973. None of the five disinterested directors had any business or professional relationships with any of the defendants (A. 147-50 and transcripts of testimony; see also Section 2(a)(19) of the Investment Company Act of 1940), and their social relationships with the defendants were non-existent or *de minimis*, as the District Court found (A.28).

To assist them in their consideration of the matter, the disinterested directors decided to retain independent special counsel. They reviewed several possible choices and then selected Hon. Stanley H. Fuld, former Chief Judge of the State of New York (A. 71). Judge Fuld had no previous connection with any of the parties (A. 138).

Judge Fuld, over the course of the next several months, reviewed and analyzed the Complaint in the *Lasker* action and the documents and depositions in the *Welch* action (A.82). He also reviewed the files of Fundamental and Anchor relating to the purchase of the Penn Central commercial paper, and interviewed the officers of Fundamental and Anchor who had knowledge of the relevant events (A. 82). In addition, he reviewed the corporate documents of Fundamental and the applicable statutes, regulations and case law (A.82).

The Fuld Report

On December 5, 1974, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum (A. 81-111). His conclusion was (A. 82):

> "As a result of my analysis of the facts and the law, *it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund,* in connection with the acquisition and retention of the Penn Central commercial paper." (emphasis supplied)

Judge Fuld also identified and analyzed the alternative courses of action available to the directors, and concluded his memorandum as follows (A. 111):

> "It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

After receiving and reviewing Judge Fuld's December 5, 1974 memorandum, the disinterested directors raised several questions regarding the subjects covered in the memorandum and the alternatives available to them. (A. 72).

In response to these questions raised by the disinterested directors, on December 18, 1974, Judge Fuld delivered a brief supplemental memorandum in which he advised, among other things, that whether or not a corporation should seek to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management and, accordingly, a matter for the business judgment of the directors (A. 72, 112-116).

The meeting of December 18, 1974

On December 18, 1974, the disinterested directors held a special meeting devoted exclusively to this subject (A. 72). At the meeting they discussed the entire matter with Judge Fuld at length (A. 73). They sought and received Judge Fuld's views as to (a) the merits of each of the claims asserted in the *Lasker* action, (b) whether Anchor had followed proper procedures, (c) the standards they should apply in determining their course of action, and (d) the alternative courses of action available to the Board of Directors (A. 73-74). They also questioned management about the facts and circumstances of the underlying transaction, the procedures followed, the nature of the commercial paper market and the likely effects to be anticipated from the different alternative courses of action (A. 74-75). The subjects covered are set forth in detail in the minutes of December 18, 1974 (A. 117-127). After several hours of discussion, they adjourned the meeting and decided to give the matter further thought before reaching a decision (A. 75).

During late December 1974 and early January 1975, Mr. Kendall, as the chairman of the disinterested quorum, spoke by telephone* with each of the four other disinterested directors, and gathered the further questions they wanted answered. Indicative of the thoughtful consideration the directors were giving to the matter is the letter written to each of his fellow directors by Mr. Stephens on December 31, 1974, a copy of which is reproduced in Addendum B at the back of this brief.

During the first week of January, 1975, Mr. Kendall conferred with Judge Fuld by telephone and reviewed the questions that he had gathered from the other disinterested directors (A. 76).

The meeting of January 6, 1975

On January 6, 1975, the disinterested directors held another special meeting of the Board of Directors (A. 76). No defendant and no one from Anchor was present (A. 137). After several hours of review and deliberation, the disinterested directors voted unanimously to instruct the fund's litigation counsel to move to dismiss the *Lasker* action as contrary to the best interests of Fundamental (A. 79). The subjects covered are set forth in detail in the minutes of January 6, 1975 (A. 137-141). The factors considered by the disinterested directors in their decision to seek dismissal of this action were summarized by Mr. Kendall as follows (A. 77-79):

> "(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

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* The five were widely scattered geographically (A. 163): Mr. Kendall lived in Wisconsin; Mr. Stephens lived in South Carolina Mr. Laun lived in Washington, D.C.; Dr. Robichaud and Mrs. O'Connor lived in different parts of New Jersey.

"(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

"(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

"(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

"(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

"(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

"(g) To take no position at all and thereby allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

"(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analyzed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

"(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be not liable to Fundamental; and

"(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

The first District Court opinion — 1975

The District Court, in its first opinion, endorsed the basic theory of the motion to dismiss, i.e., that the disinterested directors had the power, in the exercise of their business judgment, to determine that the possible corporate claim should not be prosecuted (A. 5-20). The District Court held (A. 16):

> "In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. [citations omitted]"

Pursuant to the rule of *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917) as set forth by this Court (discussed in Point I, *infra*, pp. 20-25) the District Court held (A. 17):

> ". . . the decision whether or not to sue is a matter of internal management. [citation omitted] Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue."

The District Court expressly dealt with and rejected each argument raised by plaintiffs, including the argument later relied on by the Court of Appeals, i.e., that the Board had no *power* to exercise its business judgment because of the public policy embodied the Investment Company Act of 1940 (A. 18). In rejecting this argument, the District Court reasoned that the directors of the fund should be given the chance to perform their duties with respect to management of the fund's affairs, including whether or not

a possible claim of the fund should be prosecuted in the courts. The District Court held (A. 19):

> "If they [the directors] have exercised their business judgment in good faith then a decision not to sue should be final."

To assure total fairness, the District Court then gave plaintiffs the right to conduct discovery on the issue of whether the disinterested directors were truly disinterested and independent, and denied the motion to dismiss with leave to renew after discovery (A. 20).

The discovery proceedings — 1976

Thereafter, plaintiffs conducted lengthy examinations of all five of the disinterested directors, and of John R. Haire, the Chairman of Anchor. In addition, plaintiffs requested and received two extensive document productions (A. 145-150).

The transcripts of the testimony, which are part of the record in this Court, demonstrate abundantly, as the District Court found (A. 28), that the five directors were truly disinterested and acted with complete independence of all defendants in the *Lasker* action.

The testimony showed that none of the five disinterested directors is related to any of the defendants by blood or marriage; none knew more than one or two of the 11 directors at the time they joined the Board (A. 165-69); none had any personal stake in the outcome of their deliberations (A. 147-50 and transcripts of testimony).

Furthermore, each of the five disinterested directors testified that neither he nor she had any contact whatsoever with Mr. Haire or anyone else from Anchor at any time during the period they were studying and deliberating this matter, nor had anyone from Anchor ever attempted to influence their deliberations in any way. See testimony of

O'Connor (Tr. 83-87); Robichaud (Tr. 120-125); Stephens (Tr. 130-137); Laun (Tr. 148-152); and Kendall (Tr. 217-226). The testimony of Mr. Haire is to the same effect: *"I totally isolated myself from the whole proceeding"* (Tr. 270). (emphasis supplied)

The second District Court opinion — 1977

At the conclusion of the discovery proceedings, pursuant to leave granted in the opinion on the original motion to dismiss, Fundamental, joined by all other defendants, renewed its motion to dismiss.

The District Court, in its second opinion, reviewed all of the evidence and all of the arguments raised by plaintiffs and held (A. 28):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." (emphasis supplied)

The District Court further stated that, in its judgment, the burden of proof was on plaintiffs to establish that the minority directors lacked independence, and that "[t]he unsupported contentions of the plaintiffs clearly fail to meet this burden . . ." (A. 36). The District Court then stated (A. 36-37):

> "I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit."

The District Court thereupon granted the renewed motion to dismiss (A. 38).

The Court of Appeals opinion — 1978

On January 11, 1978, the Court of Appeals reversed and remanded, holding that, *as a matter of law*, the Investment Company Act of 1940 impliedly deprived the disinterested directors of their power to determine whether or not a claim should be prosecuted against the investment adviser and various fund directors for an investment loss sustained by the fund (A. 39-48).

The Court of Appeals expressly acknowledged (A. 48):

> "We have no doubt that the five minority directors acted in good faith in all that they did."

Notwithstanding this conclusion, the Court of Appeals held that the stockholders' derivative action must be permitted to proceed to a trial on the merits, irrespective of the good faith business judgment by the disinterested directors that maintenance of the claim was contrary to the best interests of the fund.

A timely petition for rehearing with a suggestion of rehearing *in banc* was denied on March 9, 1978 (A. 170-171).

Summary of Argument

The Court of Appeals erroneously concluded that, *as a matter of law*, disinterested directors of a mutual fund cannot be trusted to reach a sound and honest business

judgment even when the District Court finds, as a matter of fact, that this is precisely what they have done—this result is an unreasoning indictment of an entire class of people, does violence to the statutory framework of the Investment Company Act of 1940 and is at variance with the legislative history and the relevant case law.

The central error of the opinion of the Court of Appeals is found in the following three sentences (A. 47):

> "[1] It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned. [2] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. [3] *It follows that disinterested directors of an investment company do not have the power* to foreclose the continuation of non-frivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties." (emphasis and numbering supplied)

The first two sentences quoted above reflect merely the subjective attitudes of the Court of Appeals—there is no support in the record for these views. The third sentence, which is the central holding of the Court of Appeals in this case, is a complete non-sequitur, having nothing to do with and not logically, legally, or factually flowing from

the two preceding sentences. The point is simply this: whether or not the directors have the *power* to do an act must be determined by reference to applicable law—it surely cannot flow from "human nature" and what "the public . . . would believe" as those two are perceived by the Court of Appeals. The opinion of the Court of Appeals, in this respect, is without basis in law.

The principal rationale set forth by the Court of Appeals for ignoring the long-standing business judgment rule was the allegedly "unique nature" of mutual fund corporations. However, there is nothing in the Investment Company Act of 1940 which expressly or impliedly supports this departure from the general rule. Indeed, to the contrary, relevant case law construing the powers of disinterested directors, as well as the legislative history and the structure of the Investment Company Act of 1940 itself, make clear that the disinterested directors do have power to exercise business judgment, even in matters involving possible conflict with the adviser. The effort by the Court of Appeals to bolster its conclusion by reading the unique provisions for review of directors' decisions found in Section 36(b) into Section 36(a), which contains no such provisions, is unfounded both as a matter of statutory construction and legislative history.

In addition, the decision of the Court of Appeals is in conflict with the principles of *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) and *Cort* v. *Ash*, 422 U.S. 66 (1975) since there is no federal statutory provision which expressly supersedes the powers of the disinterested directors under Delaware law.

POINT I

The decision to prosecute or terminate litigation brought on behalf of a corporation is a matter for the business judgment of the disinterested directors of the corporation.

In a line of cases going back more than 75 years, this Court has held that the decision whether or not to prosecute litigation on behalf of a corporation rests solely with the board of directors. Absent fraud, corruption, or similar invalidating factors, a board's exercise of business judgment that a claim should not be prosecuted is final, and a stockholder's derivative action asserting that claim may not be maintained. See, e.g., *United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261 (1917); *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455 (1903).

In *Corbus, supra,* this Court set forth the business judgment rule in the context of a litigation decision as follows (187 U.S. at 463):

> "The directors represent all the stockholders, and are presumed to act honestly and according to their best judgment for the interests of all.* Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon

* The Court of Appeals, in the case at bar, erroneously based its decision on precisely the opposite presumption.

> the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs."

This doctrine was subsequently reaffirmed by this Court in *United Copper, supra* (244 U.S. 261). In that case, the plaintiff stockholder claimed that his corporation had been damaged by the defendants' actions in violation of the anti-trust laws. The board considered suing the defendants and refused to do so. This Court ruled that the stockholder could not then maintain a derivative action on behalf of the corporation. Justice Brandeis wrote (244 U.S. at 263):

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders."

The federal Courts of Appeals in more recent cases have also adhered to this rule. See, e.g., *Cramer* v. *General Telephone & Electronics Corp.,* 582 F.2d 259, 274-5 (3d Cir. 1978); *Ash* v. *IBM,* 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966); *Swanson* v. *Traer,* 249 F.2d 854, 859 (7th Cir. 1957).

In *Swanson* v. *Traer, supra* (249 F.2d 854), the plaintiff shareholder claimed that his corporation had been defrauded in its purchase of certain properties. He asked the

board to sue the alleged wrongdoers and the board refused. The Court of Appeals for the Seventh Circuit barred a derivative suit by the shareholder, holding (249 F.2d at 859):

> "A corporation's right not to sue is correlative to its right to sue. Unless an equitable basis for intervention be shown, an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board."

In *Ash* v. *IBM, supra* (353 F.2d 491), a shareholder of three publishing corporations asserted that IBM's acquisition of another publisher violated the antitrust laws to the damage of his corporations. He requested the boards of directors of his corporations to sue IBM under the antitrust laws, but the boards refused. The Court of Appeals for the Third Circuit affirmed the dismissal of a derivative suit by the shareholder, stating (353 F.2d at 493):

> "The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring antitrust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. [citations omitted] Prevailing doctrine in the state courts is to the same effect. [citation omitted]"

In *Cramer, supra* (582 F.2d 259), the Court of Appeals for the Third Circuit affirmed the dismissal of a

derivative action on the basis of plaintiff's failure to make demand on the board of directors. In that case, a committee of independent members of the board of directors of the corporation had determined that, as a matter of business judgment, prosecution of the claim would be contrary to the best interests of the corporation. Although this exercise of business judgment was not the basis of the District Court's dismissal, the Court of Appeals analyzed the issue in depth and wrote (582 F.2d at 275):

> "Important policies underlie both the demand requirement and the business judgment rule as a bar to shareholders' derivative actions. The demand requirement enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation. Moreover, deference to the directors' judgment might terminate meritless causes of actions and prevent the corporation from incurring the costs of participating in derivative suits. Even if a particular suit has some merit, the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit.* Finally, derivative actions could be brought not to remedy wrongs to the corporation, but to induce settlements beneficial to the named plaintiff or his counsel. [citation omitted]"

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* This correct and practical analysis shows the fallacy of the distinction drawn by the Court of Appeals in the case at bar between "frivolous" and "non-frivolous" litigation (see A. 39, 40, 43 and 47). The merit, if any, of the underlying claim is merely one of many factors to be considered by the directors in the exercise of their business judgment. See also *Corbus, supra* (187 U.S. at 463). In this case, the merits of the underlying claims were the subject of detailed analysis by independent special counsel, who concluded they were without merit (A.82), and careful review and consideration by the disinterested directors (see e.g. A. 73-4, 120), as the District Court found (A. 36).

The Court in *Cramer, supra* (582 F.2d 259) also expressed the view that the business judgment of directors should not be *totally* insulated from judicial review, but that "to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing." (582 F.2d at 275). The Court added that "where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should . . . be able to conduct its own analysis of the reasonableness of that business judgment." (582 F.2d at 275).

In the case at bar, plaintiffs have not argued and could not effectively argue that the disinterested directors' judgment was "so unreasonable as to fall outside the permissible bounds of the directors' sound discretion." Thus, under the approach of the Court in *Cramer, supra* (582 F.2d 259), the business judgment of the disinterested directors in this case clearly merits judicial deference.

The issue raised in this case has also been recently addressed by three different district judges of the United States District Court for the Southern District of New York; all three have sustained the right of the directors, in the exercise of their business judgment, to forego or terminate litigation. *Gall* v. *Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Lasker* v. *Burks*, 404 F.Supp. 1172 (S.D.N.Y. 1975); *Bernstein* v. *Mediobanca Banca di Credito*, 69 F.R.D. 592 (S.D.N.Y. 1974).

The state courts, as noted in *Ash, supra* (353 F.2d 491), also follow the rule that a valid business judgment of a corporation's board of directors—including whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit. See, e.g., *Goodwin* v. *Castleton*, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944); *Findley* v. *Garrett*, 109 Cal App

2d 166, 178, 240 P.2d 421, 431 (Dist. Ct. App. 1952); *Beard* v. *Elster*, 39 Del.Ch. 153, 165, 160 A.2d 731, 738-9 (1960); *Puma* v. *Marriott*, 283 A.2d 693, 696 (Del.Ch. 1971); *McKee* v. *Rogers*, 18 Del.Ch. 81, 85-6, 156 A. 191, 193 (Ch. 1931).

For example, in *Goodwin, supra* (19 Wash.2d 748, 144 P.2d 725), minority shareholders had commenced a derivative action against certain members of the board of their corporation, charging wrongful self-dealing and waste of corporate assets. After the suit had been pending for a few years, the then board of directors settled the corporate claim with the defendants. Noting that the board of directors had found, in its view, that there had been no wrongful conduct by defendants and that the suit had no merit (19 Wash.2d at 757-8, 144 P.2d at 730), the Court dismissed the action, stating (19 Wash.2d at 764, 144 P.2d at 733):

> "Since those who conduct the affairs of the corporation or who have the ultimate power of control over it have the right, in the first instance, to determine whether a suit shall be brought by the corporation or whether an existing controversy shall be compromised without suit, so they also have the right to inquire, consider, and determine whether a suit already brought by a dissentient stockholder is well-founded, what its chances for success may be, and whether in any event its continued maintenance may injuriously affect the present or future prosperity of the corporation."*

As a matter of elementary logic, the case at bar falls squarely within this legal principle.

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* Plaintiffs have argued previously that since demand under Rule 23.1, Fed. R. Civ. P. was allegedly excused, the quorum of independent directors had no power to terminate this action. Accordingly, plaintiffs state (Brief in Opposition to Certiorari, p. 6):

> "Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination."

No case so holds, and several decisions contradict that conclusion. See, e.g., *Wolf* v. *Barkes*, 348 F.2d 994, 997 (2d Cir.), *cert.*

POINT II

The Court of Appeals erred in holding that the Investment Company Act of 1940 precluded the disinterested directors from exercising their business judgment to terminate this litigation.

In disregarding the long-standing legal principle set forth in Point I, the Court of Appeals wrote (A. 48 n. 14):

> "We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations."

The notion that mutual fund directors—especially the disinterested directors—are under a special disability in regard to exercising business judgment is not borne out by the provisions of the Investment Company Act of 1940, the legislative history of the statute or the relevant case law construing the statute.

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denied, 382 U.S. 941 (1965); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966); *Goodwin* v. *Castleton*, 19 Wash.2d 748, 144 P.2d 725 (1944). See also: *Brody* v. *Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975), discussed in the first opinion of the District Court (A. 16).

The plain fact is that Rule 23.1, a rule of procedure, cannot alter or abridge the substantive powers of corporate directors, including their business judgment powers. See 28 U.S.C. § 2072 (1978) and *U.S.* v. *Sherwood*, 312 U.S. 584, 590 (1941); *Brennan* v. *Silvergate Dist. Lodge No. 50*, 503 F.2d 800, 804 (9th Cir. 1974). If Rule 23.1 were interpreted as plaintiffs would have it, the board's posture would be frozen as of a single instant in time, and the directors would be prevented from acting in the best interests of the corporation and its shareholders in light of evolving circumstances. The responsibility of a board of directors to exercise business judgment is a continuing responsibility and the directors must have the power to fulfill that continuing responsibility.

The Court of Appeals did not, and could not, point to any express provision of the Investment Company Act of 1940 which precludes the directors from exercising their business judgment as they did in this case—there is no such provision. Instead, the Court of Appeals held that the Investment Company Act of 1940 *impliedly* prohibited them from exercising their business judgment to determine whether or not the claim asserted in the derivative litigation should be prosecuted. In so doing, the Court of Appeals based its conclusion on two premises—(1) its subjective view of "human nature" and "what the public . . . would believe", discussed at pp. 18-19 *supra*, and (2) a faulty analysis of the interplay of Sections 36(a) and 36(b) of the Investment Company Act of 1940.*

The Court of Appeals reasoned that since Congress, in the 1970 amendments to the Investment Company Act of 1940, "specifically provided in Section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser", it "would surely be anomalous" not to imply the same power for the alleged violations of Section 36(a) sued upon here (A. 45, 46). Why it "would surely be anomalous" is not explained, nor is any authority offered for the proposition.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940 —it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees,

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* Section 36(a) deals with the broad subject of fiduciary duties of investment advisers; Section 36(b), which was added to the statute in the 1970 amendments, deals solely with the subject of compensation of investment advisers.

irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.

If Congress had intended to provide in Section 36(a), which is a far broader section than Section 36(b), the unique mechanisms of Section 36(b), it could and would have done so in the 1970 amendments—it did not do so. The Court of Appeals improperly added such a provision to Section 36(a) where Congress saw fit not to do so.

The legislative history, which was not cited by the Court of Appeals, supports defendants' view. Thus, Senate Report No. 91-184, 91st Cong., 1st Sess. at 16 (1969), reprinted in 3 U.S. Code Cong. & Ad. News, at 4911 (1970), which accompanied the 1970 amendments, states:

> "Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), *the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a).*" (emphasis supplied)

The foregoing passage, although focusing on the existence of a private right of action, a subject not at issue in this case, indicates that Congress did not intend that the new Section 36(b) be read to affect, in any way, Section 36(a). In short, the subject of investment adviser compensation covered by Section 36(b) is *sui generis.*

Moreover, the Senate Report expressly reaffirmed Congress' intent not to disturb the authority of disinterested directors to manage the affairs of a mutual fund in the exercise of their business judgment (*id.* at 7, reprinted in 3 U.S. Code Cong. & Ad. News at 4903 (1970)):

> "These provisions highlight the fact that *the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of the directors.* Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation [i.e., Section 36(b)]. *The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.*" (emphasis supplied)

A fortiori, if Congress, in Section 36(b), which contains an express right of action, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary, it necessarily follows that Congress, in Section 36(a), where there is no such express right, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary.

At bar, the District Court correctly analyzed and rejected the plaintiffs' argument based on the public policy of the Investment Company Act of 1940 and held (A. 18-19):

> "This Court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provisions with respect to suits brought

under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. [citations omitted] It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

On a motion by plaintiffs for reargument, the District Court specifically addressed and rejected the Section 36(b) argument, and held, in an unreported opinion and order (A. 21):

> "That section [36(b)] specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under section 36(a) . . . where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim."

The District Court correctly perceived the distinction between Sections 36(a) and 36(b); the Court of Appeals either misperceived or ignored the distinction and, in so doing, misconstrued the Investment Company Act of 1940.

Not only is there no provision of the Investment Company Act of 1940 which expressly or impliedly deprives the disinterested directors of their business judgment power but, to the contrary, there are several key provisions which indicate that Congress intended to vest power in the disinterested directors to determine matters of the highest importance and sensitivity to the fund and its shareholders.

Section 10(a) of the Investment Company Act of 1940 provides that at least 40% of the directors must be disinterested persons. It is these same so-called "minority directors" who have the critical responsibility of approving the terms of the advisory contract between the investment adviser and the fund under Section 15(c). The Court of Appeals did not believe that these directors could be truly disinterested and independent because they "must constantly deal with interested directors in a spirit of accomodation", and because "they are compelled for the most part to rely on the information and expert advice provided by the adviser and majority directors", and because their "continued service . . . for which in this case they were paid from $11,000 to $13,000 per annum, depends almost entirely on the establishment of satisfactory working arrangements between them and the majority . . ." (A. 46-47).* If Congress had shared the belief of the Court of Appeals, it surely would not have reposed such fundamental power in the disinterested directors.**

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* None of these three factors cited by the Court of Appeals is unique to disinterested directors of mutual funds, as opposed to disinterested directors of any other type of corporation. Thus, if these factors truly were disabling, no disinterested director of any type of corporation could ever function on matters involving interested directors. Cf. Delaware Corporation Law, Section 144.

** As the District Court stated in *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass.), *rev'd on other grounds*, 580 F.2d 22 (1st Cir. 1978) in discussing revised Sections 10 and 15 (79 F.R.D. at 45):

> "When Congress has rested such responsibility on the shoulders of the unaffiliated [i.e. disinterested] directors, it would be

The recent legislative history supports the powers of disinterested directors to exercise business judgment in matters of importance to the fund. In 1970 Congress amended the Investment Company Act of 1940. One of the important areas of amendment concerned the requirements for qualifying as an outside director. Throughout the 1960s there had been criticism that the outside directors were not truly functioning as "watchdogs". In the 1970 amendments, Congress revised and made stricter the requirements for qualifying as an outside director. Congress did so by providing that such persons not only could not be "affiliated" persons as defined in Section 2(a)(3), but also could not be "interested" persons as defined in a new section, Section 2(a)(19). In doing this, Congress believed that it had satisfied the criticisms of the prior test and enhanced the role of the outside directors. As Senate Report No. 91-184, 91st Cong., 1st Sess. at 32-33 (1969), reprinted in 3 U.S. Code Cong. & Ad. News at 4927 (1970) shows, Congress sought to "remedy the act's deficiencies in this regard" in order to assure that the disinterested directors would "supply an independent check on management and . . . provide a means for the representation of shareholder interests in investment company affairs". The decision of the Court of Appeals thus prevents the disinterested directors from performing the function envisioned for them by Congress in the 1970 amendments.

The relevant case law construing the statute also supports the power of the disinterested directors to exercise their business judgment as they did in this case. The Court of Appeals for the First Circuit in the leading case of *In re*

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anomalous to assume [that Congress believed] they are captive to the interests of the investment advisers."

Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) has firmly rejected the argument that disinterested directors of a mutual fund are under a special disability in regard to exercising business judgment. The Court stated (479 F.2d at 266-7):

> ". . . the underlying business judgment may be sufficiently unsound to call for correction. But it does not follow that it is to be conclusively presumed in such a case that an unaffiliated, or disinterested director, if demand were made upon him, would be unable to exercise an independent judgment in considering what new course to take. [footnote and citation omitted]
>
> "*Nor do we think that an exception is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship.* Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. Normally self-dealing by any corporate directors is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. *In order to make sure that the directorate not be top-heavy, it* [Congress] *provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that,*

*as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from a disinterested director in any other corporate venture.** All disinterested directors must 'act honestly and according to their best judgment for the interests of all'. [citation omitted] When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim' [citation omitted], *it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response.* [citation omitted] *To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it.*" (emphasis supplied)

At bar, under the *per se* rule of disqualification adopted by the Court of Appeals, the disinterested directors were deprived of their opportunity to serve as "watchdogs" of the fund's best interests because they were erroneously *presumed* to be legally incapable of deciding on the appropriate corporate response.

The decision of the Court of Appeals is also in conflict with two of its own prior decisions on the applicability of the business judgment rule to disinterested directors of mutual funds.

* If, as stated in *Kauffman, supra,* the disinterested directors of a mutual fund have the same fiduciary obligations as directors of other types of corporations, concomitantly they must have the same powers to fulfill those obligations, including the power, as shown in Point I, to prosecute or terminate litigation.

In *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir. 1977), *cert. denied,* 434 U.S. 934 (1978), the Court of Appeals recognized that the disinterested directors of a mutual fund have the authority to exercise a binding business judgment, even on matters as to which there is a conflict of interest on the part of the adviser and the interested directors of the fund (e.g., the allocation of brokerage fees on portfolio transactions of the fund) (552 F.2d at 417):*

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors."

In *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976), the Court of Appeals also affirmed the applicability of the business judgment rule to disinterested directors of mutual funds. Chief Judge Friendly there wrote (533 F.2d at 749-50):

> "Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs'. [citation omitted] The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was

* The SEC, at the request of the Court of Appeals in *Tannenbaum, supra,* submitted an *amicus curiae* brief. In that brief, the SEC expressly acknowledged the power of disinterested directors of mutual funds to make business judgments on matters as to which there may be a conflict of interest between the advisor and the fund, provided three conditions are met: 1. the directors are independent; 2. the directors are informed; and 3. the business judgment is reasonable. These conditions were clearly met in the case at bar.

a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

"If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case."

At bar, the disinterested directors concluded that "because of legal doubts, business considerations or both" maintenance of this litigation was contrary to the interests of the fund and its shareholders. Nothing in the Investment Company Act of 1940, its legislative history or the relevant case law deprives the disinterested directors of their power to reach and act upon such a conclusion.

POINT III

The Court of Appeals erred in failing to follow the rule of this Court that state corporate law governs internal corporate affairs in the absence of an express federal statutory provision to the contrary.

This Court has specifically held that, in the absence of any *express* federal statutory provision to the contrary, state law governs the internal affairs of a corporation, including the powers of the directors. Thus, in *Santa Fe*

Industries, Inc v. *Green*, 430 U.S. 462 (1977), this Court last year wrote (430 U.S. at 479):

> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." (quoting from *Cort* v. *Ash*, 422 U.S. 66, 84 (1975)) (emphasis in original)

Fundamental, the mutual fund involved in this case, is a Delaware corporation.* Section 141 (a) of the Delaware Corporation Law empowers the board of directors of a corporation to manage the affairs of the corporation. No distinction is made under that law for mutual fund corporations.** Management of the affairs of a corporation has long been held to include the power to decide whether or not to pursue a possible claim of the corporation in litigation. See, e.g., *McKee* v. *Rogers*, 18 Del.Ch. 81, 85-6, 156 A. 191, 193 (Ch. 1931), where the Chancellor stated:

> "Of course a stockholder cannot be permitted as a general rule to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses."

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* Congress, when it enacted the Investment Company Act of 1940, left the organization of mutual funds to state law. Mutual funds are creatures of state law, *not* (like national banks, for example) creatures of federal law.

** See, e.g., *Lutz* v. *Boas*, 39 Del.Ch. 585, 608, 171 A.2d 381, 395 (Ch. 1961), where then Chancellor Seitz (now Chief Judge of the Court of Appeals for the Third Circuit) wrote: "The non-affiliated directors [of a mutual fund] had the same responsibility as that of the ordinary directors of a Delaware corporation." If the directors have the same responsibilities under Delaware law, it follows that they must have the same powers to fulfill those duties.

The Court of Appeals, however, erroneously differentiated between mutual fund directors and directors of other types of business corporations with respect to their business judgment power to determine whether or not litigation on behalf of the corporation should be prosecuted. See Point II. In so doing, the Court of Appeals engrafted onto the Investment Company Act of 1940 new limitations on the powers of mutual fund directors *not* placed there by Congress and in conflict with the plan of corporate governance intended by the law of Delaware.

The Court of Appeals did not and could not cite any provision of federal law which expressly overrides or abrogates the power of the directors under state law. The fact is that there is no such provision in the Investment Company Act of 1940 or in any other federal statute. Thus, the decision of the Court of Appeals is in conflict with the principles clearly enunciated by this Court in *Santa Fe* and *Cort, supra.*

The Court of Appeals also erroneously stressed the fact that the decision was made by "minority directors," i.e., five of 11 members of the Board (see A. 39, 40, 42, 43, 45, 47 and 48). Under Article VI of Fundamental's by-laws (A. 143) and under Delaware Corporation Law, Section 141 (b), the five disinterested directors constituted a quorum—indeed, more than a quorum. As such, they had the full power of the Board of Directors under Delaware Corporation Law, Section 141 (a). In addition, Delaware Corporation Law, Section 144 expressly empowers disinterested directors to pass upon corporate matters involving interested directors.

The decision by the Court of Appeals in this case directly contravenes these grants of authority to the quorum and, in effect, legislates new provisions of corporate law not provided for by Delaware or by Congress.

CONCLUSION

The judgment of the Court of Appeals should be reversed and the Complaint should be dismissed.

Respectfully submitted,

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November 16, 1978

ADDENDUM A

TEXT OF STATUTES INVOLVED

INDEX TO ADDENDUM A

ADDENDUM A

Text of Statutes Involved

Delaware Corporation Law

Sections 141(a) and (b) of the Delaware Corporation Law, Del. Code tit. 8, §§ 141(a), (b) (1975):

§ 141. Board of directors; powers; number, qualifications, terms and quorum; committees; classes of directors; non-profit corporations; reliance upon books; action without meeting, etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of one or more members. The number of directors shall be fixed by, or in the manner provided in, the by-laws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the by-laws. The certificate of incorporation or by-laws may

prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the by-laws require a greater number. Unless the certificate of incorporation provides otherwise, the by-laws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than one-third of the total number of directors except that when a board of one director is authorized under the provisions of this section, then one director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the by-laws shall require a vote of a greater number.

Section 144 of the Delaware Corporation Law, Del. Code tit. 8, § 144 (1975):

§ 144. Interested directors; quorum

(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall

be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if;

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

Investment Company Act of 1940

Section 2(a)(3) of the Investment Company Act of 1940, 54 Stat. 790, 15 U.S.C. § 80a-2(a)(3) (1976 ed.):

§ 80a-2. Definitions

(a) When used in this subchapter, unless the context otherwise requires—

* * *

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Section 2(a)(19) of the Investment Company Act of 1940, 84 Stat. 1413, 15 U.S.C. § 80a-2(a)(19) (1976 ed.):

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company

solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso;

* * *

Section 10(a) of the Investment Company Act of 1940, 54 Stat. 806, as amended, 84 Stat. 1416, 15 U.S.C. § 80a-10(a) (1976 ed.):

§ 80a-10. Affiliations or interest of directors, officers, and employees

(a) Interested persons of company who may serve on board of directors

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

Section 15(c) of the Investment Company Act of 1940, 54 Stat 812, as amended, 84 Stat. 1419 and 89 Stat. 165, 15 U.S.C. § 80a-15(c) (1976 ed.):

§ 80a-15. Contracts of advisers and underwriters

* * *

(c) Approval of contract to undertake service as investment adviser or principal underwriter by majority of noninterested directors

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for

any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

Sections 36(a) and (b) of the Investment Company Act of 1940, 54 Stat. 841, as amended, 84 Stat. 1428, 15 U.S.C. §§ 80a-35(a), (b) (1976 ed.):

§ 80a-35. Breach of fiduciary duty

(a) Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection

of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78*o* of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

ADDENDUM B

Stephens Letter, December 31, 1974

ADDENDUM B

Stephens Letter, December 31, 1974

(Letterhead of)

WILLIAM J. STEPHENS
21 Live Oak Road
Hilton Head Island, South Carolina 29928

December 31, 1974

Re: The Derivative Action
Lasker et al
February 1973

Dear Leon,

At this date I wish to advise that my tentative conclusion is that, in the best overall interest of Fundamental Investors, Inc., this derivative action should not be prosecuted and should therefore be dismissed.

I have given consideration to the following:

#1—Judge Stanley H. Fuld's statement contained in his letter of December 5, 1974 which reads—"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

#2—There is no hard evidence that the adviser did not exercise due care and diligence in the Penn Central transaction. The certain guidelines established for the purchase of commercial paper from dealers are evidence that this transaction was not entered into lightly. It is reasonable to conclude the guidelines were truly a sufficient safeguard.

#3—It is also reasonable for the adviser to place reliance on the presentation and recommendation of Goldman, Sachs & Co., a most astute, prestigious and highly regarded investment banker.

#4—As a purchaser, Anchor was in "first class" company and this conclusion was arrived at by an examination of the "Investor Sales Analysis" from 3/1/68 to 4/2/70, a 12 page document prepared by Goldman, Sachs & Co. Also examined was the list of 73 banks that bought and/or sold Penn Central paper, mostly for the account of customers. It seems evident that the investment community highly regarded the Penn Central commercial paper and purchased it as late as 4/2/70. The statement showed sales of $172,505,000 in this period, not including the $20,000,000 purchased by Anchor. The amount not paid at maturity was $52,205,000 including the $20,000,000 Anchor buy.

#5—Commercial Paper was fully accepted by the investment community. The outstanding commercial paper in the first part of 1970 exceeded $40 billion.

#6—In August 1968 the Interstate Commerce Commission gave Penn Central authority to sell $35 million in commercial paper. On December 17, 1968 the I.C.C. increased the authorization to $100 million. On May 18, 1969 Penn Central announced an increase to $150 million, approved by the I.C.C. On October 29, 1969 the I.C.C. agreed to permit the sale of up to $200 million. At this time the comment on the decision by the I.C.C. to increase to $200 million was, "On the whole, applicant is in a strong financial condition."

#7—Penn Central had a $50 million revolving credit plan. In April 1969, with First National City as the lead bank, the amount of the revolving credit was increased to $300 million. All $300 million was used by the railroad, which eventually defaulted on the loan. There were about ninety banks involved; the majors were First National City $35 million, Irving Trust and Morgan Guaranty $25 million each, Manufacturers Hanover $20 million, with Bankers Trust of New York, Chemical Bank New York Trust, First National Bank of Chicago and Continental Illinois Bank at $15 million each. It is clear the banks did not contemplate that the railroad would be bankrupt within 14 months!

#8—Of more than passing interest is the interlocks of Penn Central directors with the major banks of Penn Central and the railroads indebtedness to these banks as of May 12, 1970.

Director	*Bank*	*Amount*
S. Saunders	Chase Manhattan	$ 7,832,500
	First Pennsylvania	18,004,766
D. Bevan	Provident National	57,074,895
P. Gorman	Bankers Trust	26,063,106
J. T. Dorrance, Jr.	Morgan Guaranty	90,972,957
A. E. Perlman ...	Marine Midland	1,083,651
R. S. Rauch, Jr. ..	Girard Trust	49,408,188
R. G. Rincliffe ...	Philadelphia National	12,480,000
	Total	$262,920,063

On June 8, 1970 International Utilities was the largest shareholder of Penn Central with 500,000 shares. They were in the midst of taking a loss of

$8 million on their holdings. John Seabrook was Chairman of International Utilities and a Director of Penn Central.

Also it is to be noted that the total railroad indebtedness to First National City was more than $300 million. They were not represented on the Board of Penn Central.

My only comment on this is the observation that the Directors did not know or understand the "soft under belly" of the railroad until it was too late. Question?—If the Directors did not grasp the real financial posture of Penn Central, was it possible for Anchor to reach behind the scenes and get the true picture?

#9—On merger day February 1, 1968 Penn Central had assets of $6.5/7.0 billion. In just 871 days later, on June 21, 1970, bankruptcy proceedings were filed under Section 77. Penn Central was regarded as the backbone of the country's transportation system and had a "Rock of Gibraltar" stature. "Nothing can happen to Penn Central" was accepted in financial centers across the nation. "The banks are behind Penn Central," was regarded as Gospel.

#10—In part, my conclusion that the Lasker derivative action should not be prosecuted stems from my concern about the possible impact on *Anchor and Fundamental Investors, Inc.*

First, as to Anchor:

The amount involved exceeds the total assets of Anchor and, if the award was made, Anchor would cease to be a viable organization. Their ability to attract and retain skilled fund managers would be gone. It would indicate that the Fund Board believed Anchor had violated the law and breached their contractual obligations to the Fund. I do not so believe. It would be inconsistent to retain Anchor as the Fund adviser and join in a suit against them at the same time. Would the Fund flounder in the interim of changing advisers? I fear so.

Second, as to the Fund:

The impact on the Fund, as a result of public knowledge that the Board had become a plaintiff in prosecuting Anchor would probably result in heavy redemptions. This would compel distress selling of the Portfolio in the current depressed market. As of November 30, 1974, Total Net Assets were $531 million, Short Term investments $21 million, Cash and Receivables $15 million. Net Asset Value per share was $5.13. Recovery of the total amount represents about $.13 a share which is 2½%. The Net Asset Value of the shares, I believe, would be damaged by a far greater percentage if the Board supported the suit. I do not make light of the sum involved but wanted to put it into perspective.

#11—It is my tentative business judgment that the Lasker suit is without merit and that it would not prevail.

Addendum B—Stephens Letter, December 31, 1974

Summary

These are my thoughts at this time. I will await answers to some questions that other Directors and I have asked before coming to a final conclusion.

Respectfully submitted,

s/ William J. Stephens

wjs/hl

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